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SUBJECT: UNION CHIEF UP, BUDGET CHIEF OUT, AS CABINET BUSTS BUDGET  
FRAMEWORK

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Summary  
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¶1. (SBU) On May 13, about fifteen minutes after the cabinet voted 26-4 in favor of the proposed 2009-2010 budget, Ministry of Finance Budget Director Ram Belinkov resigned, citing what he felt was inappropriate handling of the budget process. Belinkov strongly objected to the profound and highly unusual involvement of the Head of the Histadrut Labor Federation Ofer Eini in the budget negotiations, at the expense of the MOF's involvement in the "package deal" that was agreed upon. The PM also had to deal with a last-minute rebellion from Yisrael Beiteinu and the Likud's Gideon Sa'ar, the Education Minister and a close associate of PM Netanyahu, who opposed cuts in the education budget. Both voted in favor in return for some last minute concessions. Only the four Shas ministers voted against the budget, unwilling to accept extension of the value-added tax (VAT) to fruits and vegetables. In a nod toward the budget framework, the annual expenditure increases for both 2009 and 2010 are defined in the budget as 1.7 percent plus an additional temporary 1.35 percent -- an effective rate of 3.05 percent. The figure is supposed to return to 1.7 percent in 2011. End summary.

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Eini Up, Belinkov Out  
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¶2. (SBU) Belinkov, a fiscal conservative closely aligned with the previous Finance Minister Roni Bar-On, objected to the deep involvement of Histadrut Labor Federation Head Ofer Eini in the negotiations and the marginalization of the Ministry of Finance professional echelon. In return for supporting the budget, Eini secured numerous non-financial changes to labor and employment laws, many of which are designed to make it easier for unions to organize. Belinkov also opposed the decision to increase year-to-year expenditures by more than the 1.7 percent rate under Israel's debt-reduction framework.

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Budget Framework Busted  
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¶3. (U) The original budget proposal, approved by the cabinet on May 3, included expenditure increases of 1.7 percent in both 2009 and 2010, and projected budget deficits of 6 percent of GDP in 2009 (NIS 44.8 billion, USD 11.2 billion) and 5.5 percent of GDP in 2010 (NIS 41.6 billion, USD 10.4 billion). In order to meet these targets, the GOI needed to make expenditure cuts of about NIS 14 billion (USD 3.5 billion). According to the budget which was approved on May 13, the expenditure increases will temporarily rise by 1.35 percent above the 1.7 percent figure for both 2009 and 2010, implying an effective annual increase of about 3.05 percent in both years. The expenditure increase is supposed to return to 1.7 percent in 2011.

14. (U) The deficit targets of 6 percent of GDP and 5.5 percent of GDP in 2009 and 2010, respectively, were maintained in the final version. However, according to numerous commentators, the government may not be able to meet these targets, and the deficits may end up exceeding them by up to 0.5 percent. (Note: The Ministry of Finance (MOF) did not issue revised data for the projected expenditures and deficits under the May 13 budget proposal. It only restated the original deficit targets from the May 3 proposal. End note). According to press reports, in 2009 and 2010 respectively, the defense budget will be NIS 46.5 billion (USD 11.6 billion) and NIS 48.5 billion (USD 12.1 billion), the education budget NIS 30.9 billion (USD 7.7 billion) and NIS 32 billion (USD 8 billion), and the health budget NIS 16.4 billion (USD 4.1 billion) and NIS 18 billion (USD 4.5 billion). The Chief Scientist's office will receive NIS 1.8 billion (USD 450 million) each year to encourage investment.

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Small Defense Cut Secures Barak Support  
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15. (SBU) After having opposed the earlier version presented on May 3, the Labor Party ministers voted in favor of the revised proposal. Despite the widespread view that there is much "fat" in the defense establishment, the Prime Minister agreed to reduce the proposed cut in the defense budget from NIS 3 billion (USD 750 million) to NIS 1.5 billion (USD 375 million), which cemented the support of Labor Party leader and Defense Minister Barak. Press reports indicate that the defense establishment is slated to receive an additional NIS 750 million (USD 188 million) in 2011 to compensate for the earlier cut. In addition the Labor Party also strongly resisted a

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long list of austerity measures proposed by the MOF to keep expenditure growth within the 1.7 percent budget framework. Those measures included reductions in allowances to numerous vulnerable sectors including Holocaust survivors, children, and the chronically ill. Publication of this list elicited a huge outcry from politicians and the press, which resulted in the PM backing away from it and the MOF having to withdraw most of the proposed cuts. Once that happened and the PM agreed to allow the budget to increase beyond the 1.7 percent framework, the Labor Party agreed to support the new proposal.

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Last Minute Negotiations  
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16. (SBU) Minister of Education Gideon Sa'ar, a Likud stalwart and close associate of PM Netanyahu, also voted in favor when he not only succeeded in blocking a cut, but secured an increase of NIS 350 million (USD 87.5 million) for his ministry. Foreign Minister Avigdor Lieberman's Israel Beitenu ministers also opposed the budget until the last minute when the Ministries of Tourism and Internal Security had their budgets increased. While acknowledging that the dropping of the social austerity measures was a significant achievement, Shas still voted against the budget primarily due to the imposition of value added taxes (VAT) on fruits and vegetables, which it claimed was a regressive measure which will harm the most vulnerable.

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Potential Revenue Generators  
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17. (U) According to the MOF and press reports, the following measures are among those expected to offset the expenditure increases:

- a 1 percent VAT increase to 16.5 percent starting from July 1, 2009 to December 31, 2010. It is estimated that this will provide additional revenues of NIS 4 billion (USD 1 billion);
- imposition of the VAT on fruits and vegetables -- exempt until now -- until the end of 2010. The rate will be the 16.5 percent, as on

all other products up from the present 15.5 percent. It is estimated that this will provide additional revenues of NIS 1.8 billion (USD 450 million);

- across the board "flat" cuts in ministry budgets of between 6 and 6.5 percent, with each ministry negotiating separately with the MOF to determine a final figure. Globes business newspaper estimates that this will save NIS 3.2 billion (USD 800 million) through the end of 2010;

- an increase in National Insurance Institute payments for those earning between NIS 38,000 and NIS 61,000 a month (USD 9,500-15,200), providing about NIS 1.5 billion (USD 375 million) in savings for the period;

- increased taxes on cigarettes, alcohol, and gas will provide NIS 1.4 billion (USD 350 million);

- a special "luxury" tax on SUVs, land cruisers and jeeps expected to raise about NIS 400 million (USD 100 million);

- and collection of about NIS 6 billion (USD 1.5 billion) a year by tightening up tax collection procedures and increasing anti-fraud measures.

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No Public Sector Wage Freeze  
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18. (U) While it had been much discussed, the final package deal did not include a freeze in public sector wages that would have saved an estimated NIS 4 billion (USD 1 billion). However, Histadrut Chairman Eini agreed to a cut in a supplemental public sector wage benefit, at a savings of NIS 2 billion (USD 500 million). In praising the Histadrut's cooperation during this budget process, Prime Minister Netanyahu said in a press briefing on May 13 that this NIS 2 billion Histadrut concession matched the amount the Histadrut agreed to concede at the height of the recession in 2003, but without any labor disruptions.

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No Delay in Planned Tax Cut  
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19. (U) Another potential source of revenues which had been widely suggested as a means of financing the increase in expenditures was a delay or cancellation of the previously-planned two percent reduction in income tax rates in 2010. Many economists recommended this as a far better way to increase revenues to the government than the imposition of VAT on fruits and vegetables - a "regressive" measure directly and negatively affecting the poor.

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Increase Taxes, Not the Deficit  
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10. (U) Vered Dar, Chief Strategist of Psagot Investment House, told the Globes business newspaper on the eve of the budget vote that tax increases would be preferable to an increased deficit, as far as the capital markets are concerned, a view also expressed in several interviews by Bank of Israel Governor Stanley Fischer. Dar was particularly opposed to increasing the VAT, saying that the tax burden on items other than income is very high in Israel compared to that in other western countries. Both she and Fischer commented prior to the budget vote that a freeze in the planned income tax reduction would have been preferable. However, according to commentators, PM Netanyahu insisted on retaining the scheduled tax cut as a symbol of his continued strong belief in the efficacy of reducing income taxes as a means to spur economic growth - just as he maintains happened when he pushed through large tax cuts as Finance Minister in 2003.

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Zigzagging Damages Credibility  
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¶11. (U) Dr. Michael Sarel, formerly the Senior Economist at the MOF worked closely with Netanyahu when he was Finance Minister and now Chief Economist at Harel Finance and Insurance, also said in a comment to Globes that the inability of the government to keep within the 1.7 percent expenditure increase framework, originally approved less than two weeks ago, is not a positive development for the Israeli economy. He said that by changing its May 3 decision so drastically, the government is "not broadcasting a message of credibility," which will create further problems for the economy. While not in favor of increasing taxes, Sarel sees such a move as less problematic in the present situation than increasing the deficit.

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Comment  
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¶12. (SBU) It was only a matter of time before the 1.7 percent expenditure framework was going to be breached. The Olmert government was strongly criticized for maintaining it when it first submitted a draft 2009 budget. The general view was that in light of the global financial crisis, the sharp drop in tax revenues, and growing unemployment, the government had no choice but to demonstrate more flexibility on increasing spending.

¶13. (SBU) Criticism of the government focused on the budget process as much as the substance, and the somewhat tone deaf attempt by the government to push through a large, deeply unpopular package of austerity. Finance Ministry officials and some political commentators criticized the major role of the Histadrut's Ofer Eini in the formulation of the final budget proposal, at the expense of the professional echelon in the MOF. Changes that may yet occur when the government submits the budget to the Knesset in mid-June, the ruffled feelings in the MOF and the resignation of the budget chief aside, the Prime Minister's involvement of Eini has bought him a period of labor peace and the buy-in of the business community, major assets in troubled economic times.

¶14. (SBU) However, the demonstrated power of Eini represents a potential long-term threat to the stability of the coalition, as he has demonstrated his strength within the Labor Party, key to the stability of the coalition. With its negative vote on the budget, Shas has also made it clear that its support for the coalition cannot be taken for granted. It is also not clear that measures such as the imposition of the VAT on fruits and vegetables will survive Knesset scrutiny, which could put further pressure on the coalition to find other money-saving measures. As Israel's debt and interest payments rise and its currency comes under increased pressure in the longer term, Netanyahu will find it increasingly difficult to maneuver between what he considers sensible economic policy and the need to maintain a stable coalition.

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